

Sustainability preferences

November 2023

Background

ESG factors and individual preferences: How the consideration of environmental, social, and governance aspects can lead to a shared and future-oriented investment strategy to create long-term value for investors and society.

In addition to considering our clients' financial circumstances, objectives, risk appetite etc. we are now taking a more formal approach to assess our clients' sustainability preferences.

Our assessment approach is consistent with the EU regulatory requirements (MiFID II Sustainability Preferences) which are part of an evolving regulatory framework that aims to advance the EU Sustainable Finance agenda. The primary goal of this agenda is to create a sustainability regulation framework that facilitates and even accelerates the flow of investment towards activities that will bring the EU economy to net zero. To achieve this, the framework includes regulation that impacts everyone along the investment value chain, from our clients, to the way we conduct our business and services, as well as the companies we choose to invest in.

The regulatory framework currently includes:

- ① The EU Directive on corporate sustainability reporting (Corporate Sustainability Reporting Directive, CSRD¹).
- ② The regulation on sustainability-related disclosure obligations in the financial services sector (Sustainable Finance Disclosure Regulation, SFDR²), which provides disclosure and reporting obligations on asset managers and investment managers.
- ③ The regulation establishing a framework to facilitate sustainable investments and to amend Regulation (EU) 2019/2088 (EU Taxonomy Regulation³), which provides a classification system to help the market identify which activities are environmentally sustainable.

In practice the regulatory framework should work as follows:

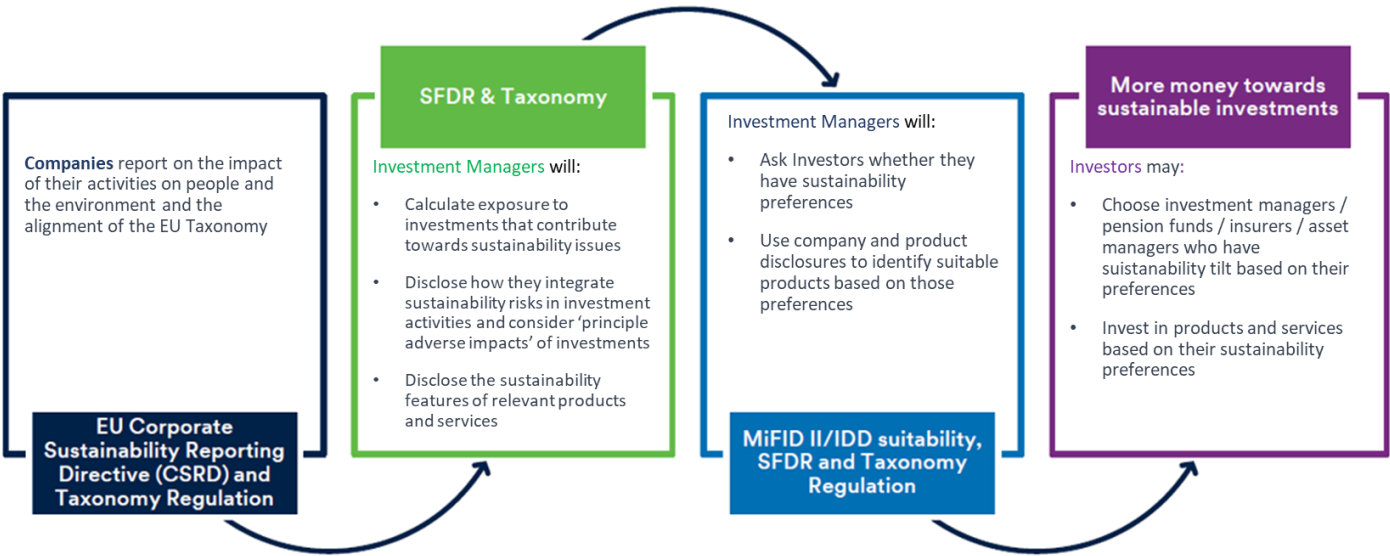
- ① Companies report on their activities, and in parallel, investment managers report on how they approach sustainability in their businesses. The aim is to increase both comparability and competition among different companies and investment products and services.
- ② Then investment managers can look at which companies have the greater push towards sustainability and which products are environmentally sustainable. They can then invest in the companies and products that meet the requirements of the clients with a preference for sustainability.
- ③ As an investor you will be able to see from the disclosures and reporting that the investments selected are consistent with your preferences.

¹Directive (EU) 2022/2464.

²Regulation (EU) 2019/2088.

³Regulation (EU) 2020/852.

Figure 1: How can regulation channel investment towards sustainable investments?



Source: Schroders.

Establishing sustainability preferences

The EU Sustainability regulations require three considerations to be presented to clients when establishing their sustainability preferences:

1. Sustainable Finance Taxonomy Regulation ('Taxonomy')⁴

The EU Taxonomy Regulation defines when an economic activity of companies can be classified as environmentally sustainable. It is aimed at all financial market participants and issuers in the EU who offer sustainable financial products. The regulation sets clear requirements that enable an investor to determine the sustainability of a potential investment as accurately as possible.

To qualify as environmentally sustainable, an economic activity must: Contribute to at least one of six environmental objectives (climate change mitigation, climate change adaptation, sustainable use and protection of water and marine resources,

⁴The EU Taxonomy's six environmental objectives.



2. Sustainable Finance Disclosure Regulation ('SFDR')

The SFDR (Sustainable Finance Disclosure Regulation) includes comprehensive provisions for the disclosure of information, particularly for companies in the financial industry. Its aim is to enable customers to obtain the necessary information regarding the sustainability of their investments. The regulation sets out requirements for financial market participants and issuers to disclose information on the environmental, social, and governance (ESG) aspects of their products and services. This allows investors to make more informed decisions based on the sustainability characteristics of their investments.

'Sustainable investment' means an investment in an economic activity that contributes to an environmental objective, or a social objective, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices.

Many European investment managers are now reporting the percentage of their portfolios that meet their own sustainable investment criteria. It is worth noting that each investment manager may apply a different definition. We can also apply this approach to direct investments, using our proprietary tool SustainEx, which relies on an analysis of companies' positive and negative externalities on society and the planet, and then applies a minimum hurdle where the sum of all externalities need to result in a net positive score.

3. Principle Adverse Impacts ('PAIs', a concept of SFDR)

PAI (Principle Adverse Impact) refers to adverse impacts on sustainability factors that an investor wishes to avoid.

In simple terms, PAIs are designed to capture any negative effects that the investments in a portfolio have on the environment and society. To measure these effects, EU regulators have come up with a list of variables such as carbon footprint or board diversity. Other variables are more niche, such as "emissions to water", which aims to capture impact on water, or exposure to energy-inefficient real estate assets. SFDR lists a total of 18 mandatory indicators and 46 voluntary indicators and requires historical information as well.

Reporting of PAIs is not accompanied by any set thresholds; there is no indication of the level from which any given PAI indicators translates into a significant harm. Such thresholds are likely to depend on regional context, sector and other characteristics of any given holding.

For example, the norms (and thus what is achievable) for a female to male board representation vary around the world and across industries. That is why the idea is to look at the indicators as absolute values and compare them across products instead of relative value compared to a set threshold.

A summary of the sustainability preferences assessment

In addition to considering our clients' financial circumstances, objectives, risk appetite etc. we are now taking a more formal approach to assess our clients' sustainability preferences.

The MiFID II regulations, require sustainability preferences to be obtained with reference to the criteria below. Clients may express their preferences using one or a combination of ways:

- a minimum proportion to be invested in environmentally sustainable economic activity as defined in the Sustainable Finance Taxonomy Regulation ('Taxonomy')
- a minimum proportion to be invested in sustainable investments as defined in the Sustainable Finance Disclosure Regulation ('SFDR')
- whether your investments should pursue environmental and/or social objectives
- a consideration of Principal Adverse Impacts on sustainability factors

If a client chooses not to express a preference, the regulation considers the client to be 'sustainability-neutral', which means investment managers can manage a portfolio which includes investments with and without sustainability-related features.

Clients expressing sustainability preferences, can only be recommend a portfolio service deemed suitable which matches their preferences. As mentioned above, due to the evolving nature of the regulation and the lack of industry-wide reliable data, applying these preferences to portfolios can have significant implications on the investment universe.

Should they wish, clients can adapt their sustainability preferences to allow recommendations considering a wider investment universe.

A current version of this information brochure can also be found on our website.



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